



# Navigating the Challenge of Rising Rates

Flexible multi-sector approach is key in a dynamic bond market.

April 2021

## KEY INSIGHTS

- Flexibility and a multi-sector approach, in our view, are essential components of fixed income portfolio management in the current dynamic market environment.
- Interest rates are still quite low by historical standards, but longer-term yields have increased amid fears about inflation as the economy reopens.
- We search for opportunities to take advantage of anomalies in this unusual environment, as well as persistent market inefficiencies, while managing risk.

Flexibility and a collaborative multi-sector approach, in our view, are essential components of fixed income portfolio management in the current dynamic market environment. Interest rates are still quite low by historical standards, but longer-term yields have increased amid fears about inflation as the economy reopens.

Markets are adapting to unprecedented levels of fiscal support and the Federal Reserve's new monetary policy framework that aims to maximize employment by allowing for periods of above-target inflation without the central bank raising rates. Our flexible, active portfolio management approach should give us opportunities to take advantage of anomalies that are present in this unusual environment—as well as inefficiencies that persist regardless of the macro backdrop—while managing risk in the Total Return and Ultra Short-Term Bond Funds.

## Historic Change in Fed Policy Framework

Other than the pandemic, the most notable recent development in financial markets is a Fed that is unlike any we have ever seen, with policymakers saying that the central bank is going to remain extraordinarily accommodative for a very long time. In fact, they are taking it a step further. In the past, the Fed would raise interest rates when the unemployment rate dropped to a level considered to be “full employment” in anticipation of rising inflation, even in the absence of any actual sign of inflation.

However, Fed policymakers have realized that inflation is much more difficult to generate than to suppress and that moderate inflation of around 2% is conducive to economic growth. Now they have vowed to wait until they see actual inflation at a healthy level before even thinking about raising rates to cool off the economy, no matter how



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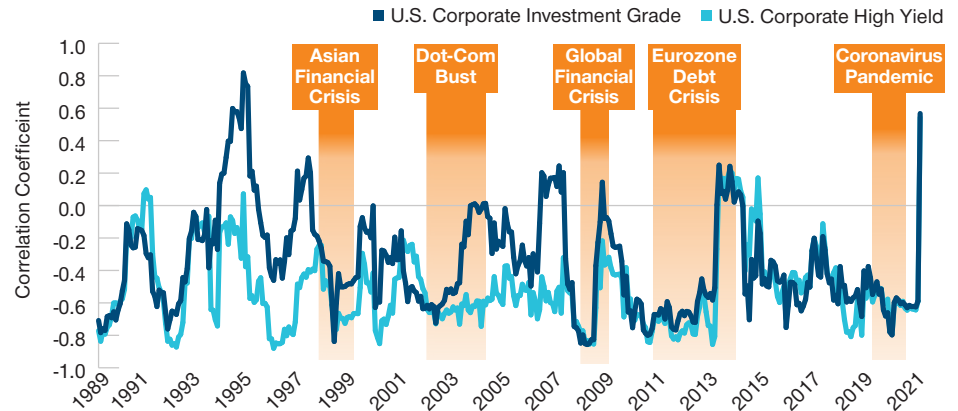


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## Treasuries Have Been Strong Diversifiers

(Fig. 1) Correlation of 10-year Treasury and credit indexes\*



As of March 31, 2021.

**Past performance is not a reliable indicator of future performance.**

Sources: Barclays Live, Haver Analytics.

\*Rolling 12-month correlation of credit index excess returns. Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a zero correlation implies no relationship at all. Excess return is calculated as the index's total return less the return of a duration matched U.S. Treasury security. Investment-grade and high yield corporate excess returns are based on Bloomberg Barclays U.S. Corporate Investment Grade and U.S. Corporate High Yield indices.

low the unemployment rate is. This is a historic change.

### Real Yields and Inflation Expectations Likely to Climb in Unison

With this new Fed framework as a backdrop, we expect intermediate- to longer-term rates to continue to generally increase in the second quarter of 2021, with both real (inflation-adjusted) yields and inflation expectations steadily climbing in unison. We see this combination as a positive indicator of a global economy that will likely continue to recover in 2021 as vaccinations become more widespread alongside continued monetary and fiscal support.

In our opinion, the increase in rates should be manageable for fixed income markets broadly as well as supportive for risk assets such as corporate bonds because the absolute level of real yields remains extremely low. Since the global financial crisis (GFC), sell-offs in bonds with credit risk have occurred when

real yields were above zero, but they are deeply negative today, and financial conditions remain loose.

### Markets Could Test Fed in Second Half

Conditions will probably become more challenging in the second half of the year as the economy opens in earnest, likely unleashing a wave of pent-up demand. This will probably be a time when the market pivots to more severely testing policymakers, both on the path of policy rates and balance sheet actions. In essence, the market is likely to say to the Fed, "We don't believe you—we think you're going to go back to your old ways and snuff this recovery out by tapering bond purchases and discussing rate hikes."

In this type of scenario, we may see real yields dominate the nominal (not adjusted for inflation) rate change, which can lead to tighter financial conditions and a strain on risk assets. We believe in the credibility of the Fed

“A multi-sector portfolio management approach allows the freedom for relative value comparisons across fixed income sectors.

and anticipate that policymakers will pass the test by staying committed to their new framework in order to maximize employment and increase inflation. However, that does not preclude heightened volatility in financial markets.

Inflation expectations have made a big move higher recently, but current levels are still within the range we have seen since the GFC. While uncertainty about inflation is high, forecasts for longer-term inflation remain tame. Although there are clearly inflation risks, we believe that slack in the U.S. labor market is greater than appreciated and that an economic reopening could likely be bumpier than markets seem to expect, both of which could restrain inflation.

#### **Flexibility to Tactically Adjust Duration**

A key part of our active portfolio management approach, the flexibility to adjust duration<sup>1</sup> in the funds, is essential in this volatile environment. Our outlook for increasing rates in 2021 has led us to maintain shorter-than-benchmark duration positions, which has helped dull the negative price effects of increasing yields. We think that rates will continue to rise, but if our outlook changes, we can adjust our positioning to lengthen duration.

Because high-quality government debt has tended to rally in periods of deteriorating risk sentiment, we believe that duration can also serve as a hedge against credit risk. Some observers have questioned the effectiveness of duration as a hedge for credit risk with Treasury yields at levels that are still low by historical standards, reasoning that Treasuries have limited room to rally.

We think that Treasuries will continue to be useful as a hedge against a steep sell-off in credit. As a result, adding duration can potentially allow us to have more exposure to credit risk. With credit spreads<sup>2</sup> relatively narrow, however, we

are seeing fewer opportunities in credit, and so we need to maintain less duration as a credit hedge. Also, with yields rising, the cost of maintaining that hedge is increasing because duration weighs on returns as rates climb. We can tactically adjust our portfolio positioning as the potential costs and benefits of duration exposure fluctuate, remaining cognizant that a “taper tantrum” type of upward rates shock would hurt both duration and credit positions.

#### **Relative Value Opportunities Across Sectors**

A multi-sector portfolio management approach allows the freedom for relative value comparisons across fixed income sectors. An investment-grade corporate bond often trades differently from a similarly rated municipal bond or asset-backed security (ABS). To a larger extent than equity markets, fixed income markets are fragmented and tend to have investors that are narrowly focused on a sector or asset class niche. This can lead to technical pressure where some dedicated funds receiving inflows will buy because they have to put cash to work, resulting in disparate cross-sector relative value. More-diversified portfolios that employ a multi-sector approach can try to capitalize on these relative value dislocations.

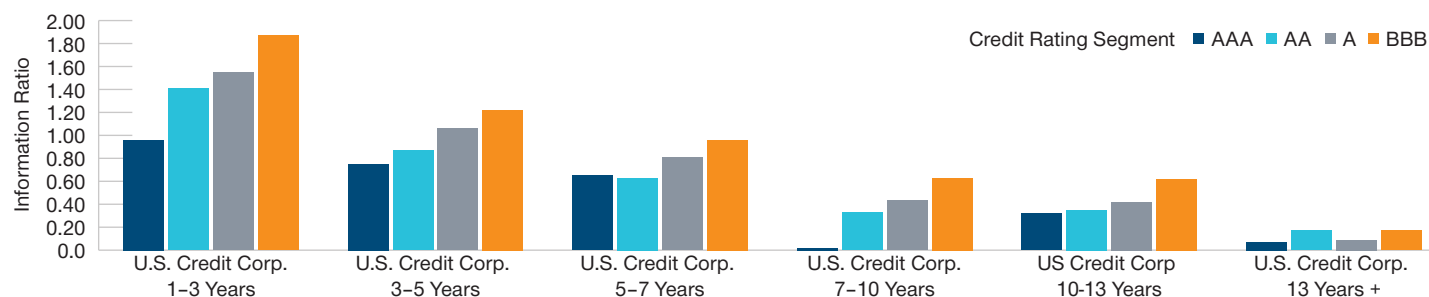
Relative value opportunities also often exist at the individual security level. Despite the lessons of the GFC, many market participants still gravitate toward nationally recognized rating organizations to do their credit analysis work for them. Our internal credit analyst team rates every security they recommend independently, which can lead to different ratings and potential opportunities to buy “mispriced” securities. Our analysts’ ratings differ from the agencies’ ratings roughly 50% of the time.

<sup>1</sup> Duration measures a bond’s sensitivity to changes in interest rates.

<sup>2</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

## Shorter-Term Corporates Outperformed

(Fig. 2) Information ratio on excess return by maturity and credit rating\*



March 31, 1998-March 31, 2021.

**Past performance is not a reliable indicator of future performance.**

Source: Bloomberg Index Services Limited. Calculations by T. Rowe Price.

\*The information ratio measures returns beyond the returns of the broad index compared with the volatility of those returns. The broad index is the Bloomberg Barclays U.S. Corporate Investment Grade Index.

### Seeking to Exploit Persistent Inefficiencies

Fixed income markets also feature some long-lasting inefficiencies that have persisted despite being well understood by many market participants. Most of these inefficiencies have resulted from imbalances between supply and demand or from investor constraints due to regulations. There are also market participants with objectives other than seeking to maximize total return, such as those constrained by punitive tax rates and those that have yield-driven performance targets.

Our quantitative research team has identified some of these anomalies and tested their robustness in various macro scenarios. As long as we have a relatively high degree of confidence that these inefficiencies will persist in the longer term and that they are appropriate for our investor base, we try to take advantage of them. This forms the basis of our strategic asset allocation and portfolio positioning. At the same time, we are aware that there are certain transient environments where positioning to exploit these anomalies could weigh on performance, and we strive to anticipate these shorter-term shifts and adjust exposures appropriately.

### Potential Areas of Structural Inefficiency

- For instance, shorter-maturity investment-grade corporate bonds historically have exhibited much higher risk-adjusted returns than longer-term corporates. As of March 31, 2021, the Total Return Fund held a credit curve steepener—overweights to shorter-duration corporate credit and underweights to longer-duration corporates—to try to capitalize on this structural inefficiency. We have also observed that credit derivatives tend to perform better in credit sell-offs than cash bonds.
- In another example, credit quality constraints prevent some investors from holding non-investment-grade securities. When a bond is downgraded from investment grade into the high yield universe, forced selling from these investors can push prices lower than what the bond's fundamentals would dictate. In the Total Return Fund, we try to capitalize on the relative value that can often be found in these “fallen angels.”
- Securitized credit, which includes commercial and non-agency residential mortgage-backed securities in addition to ABS, is

another area of structural inefficiency. Some investors were restricted from owning securitized debt after the GFC, and some lack the ability to analyze the often-complex cash flow structures of the securities. T. Rowe Price's team of securitized credit analysts have the capability to value these bonds, allowing us to locate what we believe are attractive securities and segments that other investors may overlook.

### **Flexible Multi-Sector Approach**

While intermediate- and longer-maturity Treasury yields have been increasing, it is important to keep in mind that our flexible multi-sector approach to managing the Total Return and Ultra Short-Term Bond Funds has allowed us to shorten relative duration and take advantage of relative value among sectors to help offset some of the negative price effects of rising rates. Even in an environment of increasing

yields, the income and relatively low volatility of a fixed income allocation make it an important part of a broader portfolio's asset allocation.

It must be mentioned that having the platform at hand that we do at T. Rowe Price is invaluable to us on so many levels when facing challenging market conditions. As a firm, we have tremendous expertise across the globe, reaching across the capital structure from investment-grade debt to equity, across all sectors, across macro and micro, and across fundamental and quantitative. In our view, these resources are an advantage in managing a multi-sector fixed income portfolio when it comes to everything from navigating changing market dynamics to constructing portfolios to just plain old good fundamental security selection.



### **WHAT WE'RE WATCHING NEXT**

Commodities prices have enjoyed a strong 2021, with crude oil prices up almost 20% for the year through late March. Because strong commodities prices can help push inflation expectations higher, we are monitoring the effects on oil and other commodities of the boost in demand as the economy more fully reopens.

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